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THE IMPACT OF GLOBAL FINANCIAL INTEGRATION ON MAURITIUS AND SEYCHELLES

*Peter Larose**

Abstract.

This paper focuses on the obstacles and challenges of global financial integration faced by Mauritius and Seychelles, two small islands states in the Indian Ocean. It is argued that globalisation is rapidly, and to a large extent irreversibly, changing the way business and policy are conducted in small open economies and in the industrialised world. The paper also refers to the difficulties faced by small island states in their attempt to liberalise their economies, notably those related to intensification of competition, maintenance of sound macroeconomic policies, effective management of risks, cross-border bank supervision, modernization of financial legislation, and adaptation to changes in the international business cycle.

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Introduction

Globalisation has ushered in a process of integration of the world economic and financial systems. The growing interdependence of the global financial markets into a mega market place was evident during the Asian financial crisis of the later nineties and the simultaneous downturn in stock markets across the world over the past three years. Even though remote small island states like Mauritius and Seychelles were not connected with the origins of such crises, the effects crossed their borders uninvited. Whether we like it or not, financial globalization is a phenomenon which is rapidly changing the world economic landscape.

For the developing nations, including numerous small open economies, the only way to become part of the global financial market is to undertake reforms through financial liberalisation and institutional adjustments. It is increasingly being recognised that market liberalization can usher in a number of benefits including access to the international capital market and an improvement in living standards within the country.

As has been shown in many studies[1], small island states tend to be economically vulnerable as a result of their high degree of exposure to external economic conditions. This means that their financial development is likely to be dictated mostly by forces outside their control. In other words, changes associated with intense competition, maintenance of sound macroeconomic policies, management of risks, cross-border bank supervision, and modernisation of financial legislation are likely to be, to a large extent, influenced by events in larger countries.

The rest of the paper is organised as follows. The process of economic reforms and financial liberalisation in the two Indian Ocean small island states is discussed in Section 2, while Section 3 deals with the main financial market changes that accompanied such reforms in these states. Section 4 addresses the globalisation challenges faced by small island states with particular reference to financial integration. The sixth section concludes the paper.

1. See for example Briguglio (1995), Crowards (1999) and Commonwealth Secretariat (2000).

Financial Liberalisation Reforms

Pre-Reform Policies on Mauritius and Seychelles

In the mid-1970s Mauritius and Seychelles were highly dependent on their agricultural sector to generate income and employment. Being small open economies, they were very exposed to changes in global demand for primary products. This led to high volatility in incomes and to adverse terms of trade. This spurred the authorities of these countries to develop their tourism and financial services sectors as a means of increasing productivity and economic resilience.

Mauritius

The island of Mauritius is situated in the Southern Indian Ocean, east of Madagascar, with a population of approximately 1.3 million people. Mauritius gained its independence in 1968. On the economic front, Mauritius has made a significant effort in its endeavour to become part of the global financial market. The island has been transformed from a low-income agriculture-based economy to a middle-income diversified economy with growth in tourism, industrial, and financial services sectors. During the fiscal year 1999-2000, the economy experienced remarkable growth, ranging from 5% to 6% annually. The rate of inflation for the fiscal year 1998-99 was approximately 8% per annum. The main trading partners of Mauritius are the USA and Europe respectively (Bank of Mauritius, 1999).

In comparison with other small islands in the Indian Ocean region, Mauritius is a leader in financial services, with a notable offshore banking sector. The offshore banks in Mauritius offer a wide range of services including foreign exchange dealing, lending, deposit taking, trade finance, offshore trust and securities and fund management. In 1999, the Mauritian banking sector was made up of 10 domestic banks, 10 offshore banks, 7 non-bank financial institutions authorised to transact deposit taking business, 3 money changers, and 2 foreign exchange dealers.[2] The Stock Exchange of Mauritius (SEM) started operations in July 1989. In 1999, 47 companies were officially listed with a market capitalisation value of MRs 38.4 billion.

2. For more information, see Annual Report and Accounts of Bank of Mauritius – 30th June 1999.

The Bank of Mauritius, being the Central Bank, is at the heart of the island's banking system. Commercial banks in Mauritius are required to publish 6-monthly audited accounts in addition to the annual audited financial statements as part of their regulatory requirements.

Privatization Reforms. In the case of Mauritius, reform commenced in the early 1980s when the government introduced a series of financial and fiscal policy measures to liberalise the economy and prepare the country for global integration. These measures were principally evoked through a Stabilisation Adjustment Programme (SAP) with the International Monetary Fund (IMF) to reduce inflation, demand for consumption, the budget deficit and public spending, and implement an incomes policy.

In addition, the SAP agreement also required the government of Mauritius to pursue economic growth through investment in the productive sectors including agriculture with the aim of improving the country's foreign exchange reserves. The country is now reaping the benefits of the SAP (Bank of Mauritius, 1999).

In connection with the privatization programme, the Mauritian authorities introduced a series of measures in 1984 including the liberalization of imports, removal of non-tariff barriers, promotion of local manufacturing enterprises for the domestic market, and provision of strong incentives for exports of manufactured products. The measures included the implementation of Agricultural Development Certificates (ADCs), aimed at increasing non-sugar agricultural production for exports.

Export Promotion. The legislation to revitalise the industrial sector in Mauritius, which was introduced in the 1970s, led to the establishment of the Export Processing Zone (EPZ). The main objective of this policy was to create employment in the manufacturing sector. The creation of the EPZ has been instrumental in generating incomes and export earnings and providing employment (Pochun, 2000). The EPZ Act was followed by the introduction of Development Certificate Incentives Act 1980, the Export Service Zone Act 1980, Industrial Buildings Certificates Act 1980, and the Industrial Expansion Act 1993 (Pochun, 2000). In 1985 the Mauritius Export Development and Investment Authority was set up with the aim of promoting exports and attracting investments in the manufacturing sector.

Technological Development. Reform in Mauritius was also directed atpromoting technological development. In 1994 the Mauritian Government introduced the Technology Diffusion Scheme (TDS) with 50% participation by the World Bank.

Project for Competitiveness Enhancement. The objective of the Competitiveness Enhancement Scheme (CES) was to assist entrepreneurs to set up their competitiveness through the use of technical expertise and new technology. At least 150 enterprises benefited from the scheme.

SMEs Policy. In Mauritius, the Small and Medium Industries Development Organisation (SMIDO) was established in 1980 with the aim of providing support and technical assistance to the small businesses. As part of the government's drive to support the small business community, the Development Bank of Mauritius also launched the Small Enterprises Financing Scheme. Likewise, the commercial banks are also encouraged to offer soft lending to the small entrepreneurs. One of the principal benefits of this scheme was to induce unemployed persons to create small enterprises.

Investment Promotion. The growth in the national income derived from the Mauritius EPZ sector from 1985 to 1992 had to be maintained. As a result a host of double taxation avoidance agreements were signed with a number of countries namely: Hong Kong, Taiwan, China, Germany, United Kingdom and France. In addition, Mauritius also introduced the Investment Promotion and Protection Agreement in order to protect and encourage inward investments. The result is that Mauritius attracts more foreign direct investment in comparison with other islands in the Indian Ocean.

Capital Market Development. The main objective of the launching of the Stock Exchange in 1989 was to modernize the financial system of Mauritius with a view to integrate within the global financial market. Not only has the development of SEM been able to change the local investment culture but it has also modernized the financial services sector which now contributes about 11% of Gross Domestic Product. Furthermore, SEM has helped the country to attract foreign investment. It must be noted that Mauritius is the only Indian Ocean island which has a stock exchange.

In line with the development taking place in the financial services market, the Mauritius Offshore Business Activities Authority (MOBAA) was set up with the objective of promoting offshore business activities, which include international financial service, consultancy, shipping and ship management, aircraft financing and leasing, fund management and banking. The Central Depository and Settlement Company Ltd. (CDS) started its operation in October 1997 with the principal objective of clearing and settling transactions in the over-the-counter market.

Banking Reforms. The Bank of Mauritius, being the country's Central Bank, introduced repurchase transactions (Repos) with effect from 15th December 1999. This measure was aimed at promoting efficient liquidity management in the market. Both the repos and reverse repos are conducted through an auctioning process under the umbrella of a Master Repurchase Agreement between the Central Bank and all commercial banks. Furthermore, on the 15th December 1999, the Bank of Mauritius introduced a standing facility under the Lombard Facility Scheme.

This facility was to provide overnight-collateralised advances to commercial banks, and it is operated on the initiative of the commercial banks. The facility is also used as an indicator in monitoring the country's monetary policy stance. Subsequently, on the 3rd March 2000 the Bank of Mauritius introduced a rediscounting facility to the commercial banks dealing with the EPZ export bills denominated in Euro. The purpose of this facility was to provide relief to the EPZ by offsetting some of the adverse impact of the movement in the exchange rate of the Euro on their exports. The reforms undertaken are having a positive effect in the banking community.

Private Sector Participation. Mauritius recognized that the private sector has a significant role to play in the economic development if the country wants to become part of the global financial market. In the island state, there is a Joint Economic Council, which allows close collaboration between Government and the private sector to address issues of national interest.[3]

The Seychelles

The Seychelles is a group of over one hundred islands situated in the Indian Ocean, south of the Equator. According to the National Census Report in August 2002, Seychelles has a population of 81,000 people. The group of islands became a Republic in 1976 after gaining independence from Britain.

3. For further details, See, report of the Joint Economic Council (JEC) Task Force: the Economic Transition of Mauritius, July 2000.

The country has its own parliament with judicial and legislative systems. During the colonial era, Seychelles was an agricultural- based economy like many other small states. The country is now a more diversified economy with tourism, fisheries, and offshore banking sectors contributing to the national income. The tourism sector employs about 30% of the labour force and contributes more than 70% of the country's foreign earnings. The Seychelles International Business Authority (SIBA) is an independent corporate body responsible for the promotion of Seychelles as an offshore jurisdiction. The companies located in the Seychelles International Trade Zone (SITZ) are offered a list of benefits, including no corporation, trades, capital gains, and withholding taxes, no social security contributions, and no restriction to foreign ownership. The SITZ also offers other advantages such as the possibility to employ exclusively foreign labour, efficient company registration facilities, and guaranteed residency for owners and operators.

The banking system facilities include, electronic banking, automated teller machines, SWIFT and Direct Debits. As at 31st December 2000, the banking system comprised 6 commercial banks, 2 money changers, 1 non-financial institution authorized to transact deposit taking business, and 1 development bank. Seychelles is yet to launch its stock exchange based on a feasibility study which was concluded in 1995. The Central Bank of Seychelles is the sole regulatory and supervisory agent of the financial system including the implementation of the macroeconomic policies.

Privatization Reforms. In the case of Seychelles, it was in 1993 that the Government felt the need to embark on a privatization programme. The programme was designed to promote a free market economy with the intention of progressively integrating into the global market. Contrary to Mauritius, the Seychelles did not sign any adjustment programme with the IMF, but has co-operated on a consultative basis until today.

The liberalization process of the financial system in Seychelles took place on two fronts, namely (1) the privatisation of the state-owned enter- prises, and (2) the provision of financial and fiscal incentives to investors. This policy attracted significant interest by private investors.

Export Promotion. Like other small states in the region, Seychelles has also launched export promotion policies. The International Trade Zone Act 1995 was enacted to offer business concessions to potential investors operating in the Seychelles International Trade Zone (SITZ). It is reasonably surmised that the businesses operating in the SITZ contribute significantly to national income.

Technological Development. With regard to technological development, reform in the Seychelles was based on offering business incentives to investors wishing to invest in new technology as a means to improve productivity or economic efficiency. The incentives are based on either concessionary financing or accelerated depreciation rate on capital investment (Central Bank of Seychelles, 1999).

SMEs Development. The Seychelles' authorities support the development of small enterprises. In 1995 a Small Business Bureau was established as a division of the Seychelles Industrial Development Corporation (SIDEC) to assist entrepreneurs who want to start, improve or expand a small business. In another development, in 1996, the Government established the Youth Enterprise Scheme (YES) in order to provide soft loan financing and other administrative assistance to young entrepreneurs with viable business plans. During the year 2000, the Government also established a Small Business Finance Facility (SBFF) with the aim of providing concessionary foreign exchange finance to small businesses with export potential. Likewise, the Development Bank of Seychelles also supports small business entrepreneurs with development finance. The effect is that foreign investors are now co-operating with many local partners in setting up businesses geared towards export markets.

Investment Promotion. To facilitate inward investment, the Seychelles Government established investment legislation during the years 1994 and 1995, including the International Business Authority Act 1994, the International Business Companies Act 1994, the International Trusts Act 1994, and the Investment Promotion Act 1994. The different pieces of legislation were designed to attract foreign direct investment. In November 1995, the National Assembly approved the Economic Development Act, which was intended to complement the existing investment legislation. Like Mauritius, the Seychelles has also signed a Double Taxation Treaty with China, Indonesia, and South Africa.

Capital Market Development. Although, as stated previously, the Seychelles does not have a Stock Exchange as yet, the Securities Industries Act 1996 was passed with the intended purpose of the setting up of a capital market. The Flemings Investment Banking Group has already completed a feasibility study. The Government plans to modernize the financial system and facilitate its integration with global markets (Fleming Investment Bank Corporation, 1995).

Banking Reforms. As part of its programme to modernise the financial and banking system, the Central Bank of Seychelles (CBS) amended its 1982 Act. This was followed with new legislation such as Financial Institutions Act 1984, Minimum Capital Regulations 1986, Financial Institutions (Domestic Banking Business) Regulations 1996, and Financial Institutions (Non-Domestic Banking Business) Regulations 1996. From a prudential aspect, CBS also introduced a Local Asset Ratio[4] of 50% of the total eligible deposits of the commercial banks in the year March 1988. This ratio was increased to 70% in September 1998. As a result of changes in the economic environment, this ratio has subsequently been reduced to 50% with effect on the 1st November 2001.

In addition, commercial banks are also required to maintain a minimum of cash reserve of 2.5% with the CBS. In order to minimize the impact of the parallel market activities in the foreign exchange market, the Foreign Earnings (Regulation) Act 1996 was enacted on the 1st January 1997. In the same year, the inflow of foreign exchange receipts in the commercial banking system grew by 27%.

Private Sector Participation. As is the case in Mauritius, in the Seychelles there is a Joint Economic Council which allows close collaboration between Government and the private sector to address issues of national interest.

Many Repurcussions of the Reforms

The financial reforms undertaken during the nineties by the governments of the two Indian Ocean small island states have had a number of repercussions. Here we consider the major changes relating to interest rates, savings, inflation, debt burden, foreign direct investment and financial integration.

[4] . In the context of the Seychelles Banking regulations, the Local Asset Ratio is defined as the cash reserves to eligible deposits that commercial banks are required to place with the Central Bank of Seychelles (CBS). This instrument is used by CBS to influence liquidity of the commercial banks

Interest Rates

In Mauritius, both the discount and money market rates fluctuated, with the money market rate averaging around 10%. The rate for the Treasury bill in Seychelles progressively declined. This was attributable to the Government reliance on the Central Bank for extra borrowings to pay for its expenditure as a result of continued public finance deficits.

The interest rate spread, that is the average lending interest rate over the deposit rate (commonly referred as the net interest margin) for commercial banks in the two island states, progressively increased during the last 10 years. In spite of the attempts by the governments of the two island states to attract foreign capital through a higher rate of interest, the results have not been encouraging.

The rate of return on investment in the Indian Ocean island states has been in decline over the years, especially during the last decade.

Savings

The savings ratio for the two island states was relatively low and did not meet the monetary authorities' expectations. This was principally due to the fact that inflation rates were well above the interest rate offered to savers – hence producing a negative rate of return in real terms. On the other hand, this situation encouraged borrowing for consumption purposes.

Inflation

The monetary authorities of the two island states under consideration have traditionally focused on consumer prices, as measured by the Consumer Price Index (CPI), as the appropriate measure of inflation for the conduct of monetary policy. In Mauritius, the rate of inflation decreased from 10.7% in 1990 to 8% in 1999. Seychelles experienced rapid rises in domestic prices, where the CPI increased from 3% in 1990 to 7% in 1999. Such inflation was fuelled by government expenditure which increased rapidly as a percentage of GDP during the decade under consideration.

Domestic and Foreign Debt Burdens

Financial reforms were also intended to alleviate the debt burden of Mauritius and the Seychelles. This, however, has not been the case. On the contrary, these islands have progressively incurred more debts, both domestic and foreign, during the last decade.

Foreign Direct Investment

Foreign direct investment flows are usually associated with strong economic fundamentals and strong stock market performance. In the case of small open economies, where economic risks tend to be high, the return has to exceed that in the industrialised nations. Mauritius and Seychelles have benefited from inward capital flows in their respective economies during the last 10 years, with Mauritius being the larger beneficiary. The principal reason behind this success is that the Government of Mauritius is committed to a modern commercial policy backed by sound macroeconomic fundamentals.

The economy of Mauritius is well diversified compared to the other islands states in the Indian Ocean. Most of the inward investments are generated from Hong Kong, South Africa and other Asian countries. Mauritius is the only island in the Indian Ocean with an active stock market. In the case of Seychelles, there is an element of competition for foreign direct investments with other island states in the region. Like Mauritius, the Seychelles has been progressively promoting all its economic sectors including the financial services as a means of increasing national income.

Financial Integration

Integration can be at the regional and at the global level. At the regional level, attempts have been made to form a Regional Integration Association (RIA) in the Indian Ocean bringing together Comoros, Reunion, Madagascar, Mauritius and Seychelles. This association was established with the objective of establishing a regional framework for improving trade relationships among member countries. At the international level, various organizations, notably the World Trade Organization (WTO) have had an effect on Africa and the Indian Ocean Island states. The reforms described above were in part aimed at satisfying the requisites of the WTO and enable the two island states under consideration to form part of the international community working towards freer and fairer trade between nations.

Globalisation and Small Island States

Though being remotely located in the Indian Ocean, Mauritius and the Seychelles cannot be isolated from the globalisation process. These island states have no option but to take advantage of the process, and adapt themselves to its challenges.

The most important challenges in this regard relate to:

- more intense competition;
- the need to adopt sound macroeconomic policies;
- the need to manage risks;
- the upgrading of cross-border bank supervision;
- the modernisation of financial legislation; and
- grappling with the high rate of exposure to the international business cycles.

Competition

Being part of a global financial market necessarily implies more intense competition in all economic activities including financial services. It has to be kept in mind that there are many island jurisdictions competing with larger and better resource-endowed countries in a variety of goods and services, notably in tourism and financial services. In the case of financial services, small jurisdictions have to compete with giant financial centres, like London and Frankfurt. One problem with small states in this regard is that a free-market mentality is often difficult to instil, given that many small states have for a long time been accustomed to protective policies, which sheltered their industries from international competition.

As a result of the process of globalisation, gone are the days when a country could shelter itself from international competition through a wall of protection. Because it is now widely accepted that protective policies lead to inefficiencies, corruption and ultimately to economic backwardness. It is also due to impositions by international agencies and entities such as WTO, as well as the consulting number of obligations, including the removal or reduction of trade barriers. However, opening up the domestic markets will not necessarily lead to economic success, and those countries that fail to upgrade their productivity or to promote innovation may end up as losers in the competitiveness game. Small states are no exception, and given their limited capacity, they may have to work harder to enjoy a competitive edge. In the case of banking and finance, Mauritius and Seychelles must modernise their financial institutions. Given the intense competition in this market, an appropriate strategy for these small states would be to provide niche financial services, which while being distinctive and innovative, will not transgress the rules of prudence and fair play.

Sound Macroeconomic Policies

The integration of the small states into the global financial market does not only require compliance with financial conditions set by international financial institutions, such as the IMF, but also continuous effort by the authorities to maintain sound internal macroeconomic policies. These policies involve external current account equilibrium, disciplined fiscal policy, transparent management of exchange and interest rates, stability oriented monetary targets, and price stability.

With regard to Mauritius and Seychelles, the most pressing challenge in this regard would seem to be related to the fact that they are very much exposed to economic forces outside their control. All countries are to some extent exposed to external factors, but small states are particularly more vulnerable in this regard, and the success of their domestic macroeconomic policies will depend on external as much as, if not more than, on internal factors. Thus, for example, an independent monetary policy in a small state is practically impossible. Attempts to control inflation in such states can be thwarted by imported inflation, given that imports constitute a large proportion of final expenditure.

Management of Risks

Exposure to international transactions on a limited range of goods and services will inevitably lead to greater risk of fluctuations in economic activity associated with insufficient diversification within a scenario where small countries can exercise little control, if any. These countries inevitably end up as price takers, with their economic activity reflecting the international demand for the narrow range of commodities in which they must specialise in order to attain a degree of economic efficiency. In order to overcome these problems, small states could consider product and factor market integration with larger trading blocks as a stepping stone to competitive success in a globalized market-place.

The digital economy also has risk implications with regard to the taxation system. With cyber payments gaining popularity in international transactions, it is evident that there is a greater risk of tax evasion. In order to tackle such risk, the authorities of the respective country must collaborate within the region and with international jurisdictions.

The Need to Upgrade Cross-Border Bank Supervision

The Asian financial crisis and its contagion effects on Europe, the USA, South America and Africa are evidence enough of the challenges, which financial globalisation bears with regard to national regulation and supervision. In order to counter such challenges, small island states, which, as stated, have limited capacity, must work in close co-operation and collaboration with international regulatory and supervisory agencies. There is a need to exchange data and information at national, regional, intra-regional and international levels. Effective supervision in the banking sector will reduce the risks associated with banking crises and promote public confidence in the financial institutions of small states.

Modernisation of Financial Legislation and Institutions

Some small jurisdictions have succumbed to the temptation of allowing money laundering activities in their financial institutions. This represents a threat to the stability of the international financial markets, and gives a bad reputation to the jurisdictions concerned. The Indian Ocean small island states should do their utmost to avoid such pitfalls, and should develop their financial sectors in line with the OECD guidelines, while at the same time, taking steps to modernise their financial legislation and introducing control mechanisms to detect unlawful activities.

High Rate of Exposure to External Forces

Arguably the most difficult challenge, which all small states face as part of the global integration process, is that they are economically vulnerable. For example, when there is a recession in Europe and in other industrial countries, the tourism sector of Mauritius and Seychelles and of many other small islands states can seriously be hampered. This is a systematic risk, against which small states cannot be protected with an insurance cover against loss of national income. In addition, small open economies are also vulnerable to developments in the global trade regime, over which they have no influence at all (Davenport, 2001; Exaith and Keiji, 2001). It is therefore very important for these states to take measures to step up their resilience in order to enhance their ability to withstand and manage their vulnerability (Binger, 2002).

Conclusion

Financial globalisation presents new opportunities for the small island states, since this could give them a larger share in the financial services market, better access to the global capital market, and improvements in their standard of living. However, there are a number of challenges that need to be met, including facing international competition, maintaining sound macroeconomic policies in the face in exposure to external forces, and adequately supervising cross-border banking activity. Other challenges relate to the turbulence associated with the modernisation process in line with changes in international business.

It is suggested that small states will be more successful in meeting the challenges of financial integration if they promote regional integration first and foremost. This demands a solid and concerted effort by all policymakers in the region, and above all a strong political will to make it happen.

At the global level, small states must be adequately prepared to meet the challenges of financial integration through structural adjustment of their economy, and encouragement of innovation and efficiency in the financial system. These states should also co-operate fully with each other and with relevant international organizations, such as the IMF and WTO.

At the same time, however, the industrialized nations must recognize the constraints faced by small states in fully integrating in the international financial markets, mostly due to their economic vulnerability, thin financial markets and overall limited human and physical resources.

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